STAFF REPORT

TO: Planning & Economic Development Committee

FROM: Gary W. Jackson, City Manager **Prepared By:** Charlotte Caplan
Community Development Director

DATE: October 11, 2006

SUBJECT: Eagle/Market Streets Redevelopment Plan

Summary Statement: Eagle Market Streets Development Corporation (EMSDC) is requesting that the City obligate $775,369 in CDBG Section 108 loan funds and $340,000 in Economic Development Initiative (EDI) grant funds for the rehabilitation of its property at 17-23 Eagle Street (the Collette Building) and 38 South Market Street (the Del Cardo Building).

History: These funds were budgeted by Council in April 2004 for an earlier EMSDC project that included construction of an infill building behind the Collette and Del Cardo buildings. That project became the subject of a law suit, which delayed the project enough to prevent it going forward.

On April 12 this year, the PED Committee requested interested parties to make fresh proposals for redevelopment in the area, and on September 13 EMSDC presented its "Rehab First" proposal to the Committee. EMSDC will form a partnership with three local investors, Jay Stewart, Doug Beatty, and David Moore (SBM) to carry out the rehabilitation of the two buildings. Major new construction along S. Market Street is expected to take place in later phases in partnership with Cherokee Investment Partnership, LLC, but that is not the subject of this proposal.

Funding Issues: The City received the **$800,000 Section 108** guaranteed loan in August 2003 for the original redevelopment project. Since then, we have repaid to the Treasury a total of $156,135[1] in interest and principal repayments. We need to use the loan funds in a project which will generate program income for future loan repayments. There is no time limit on use of the funds and HUD will allow transfer to any eligible project that meets its underwriting criteria.

The **$340,000 EDI grant** must be expended alongside the Section 108 loan, not before, and must be **fully expended by September 30, 2007** (non-waivable). Unlike the Section 108 funding, it is not transferable to another project, but a scaled down version of the original project may be acceptable to HUD.

Review of The Proposal: In principle this is a simple proposal to rehabilitate two dilapidated historic buildings for retail and office space. The total estimated project cost

[1] Only about $19,000 of this was taken from the loan balance. The remainder has been met from repayments received on an earlier Section 108 loan used for housing rehabilitation, and from CDBG entitlement funds.

is $2,114,000 or $162 psf, including acquisition, rehabilitation, and soft costs. The project would not be feasible if it depended wholly on loan financing. Key elements in the financing are therefore the EDI grant, the $300,000 equity investment proposed by SBM, and the $410,000 equity contributed by EMSDC in the form of property acquisition and other costs already met from CDBG grant funds.

EMSDC has proposed an organizational structure in which it will retain 100% ownership of the Del Cardo building, and be solely responsible for its rehabilitation, while rehabilitation of the Collette building will be a joint venture between EMSDC and SBM, managed by SBM. SBM intend to increase their rate of return by applying for historic rehabilitation tax credits for the Collette building (not shown in the proforma).

Staff have closely reviewed the development pro-forma and discussed it with the development partners. Overall, the project appears to be feasible with the proposed financing structure. However, there are features that make this a particularly risky project:

1. As yet, there is no detailed plan for the rehab work. The per square foot costs are estimates based on recent costs for other buildings elsewhere. Furthermore only 5% has been allowed for contingency. Cost over-runs are therefore a real risk.
2. The rent assumptions appear to be reasonable based on staff knowledge of downtown rents. However, no professional market survey has been done (the survey included in the proposal is 3 years old and for residential property only). The 5% vacancy assumption is optimistic. There is therefore a risk of the project failing to make debt repayments after completion.
3. The single pro-forma for the entire development does not reflect the complex organizational structure. It needs to be separated for the Del Cardo and the Collette buildings. That may reveal further financial issues.
4. The partners have explained to staff that the intention is for the Collette building to be financed solely from equity and the bank loan, with the Section 108/EDI funding being reserved for the Del Cardo. It seems unlikely that this financing structure will exactly coincide with the costs of the two buildings, and it also increases the risk of not spending the EDI funds in time (see item 6 below).
5. Because EMSDC is a non-profit, it cannot use rehab tax credits for the Del Cardo. A different organizational structure might enable more tax credits to be utilized.
6. The greatest element of risk is timetable slippage. Any EDI funds not drawn down from the Treasury by September 30, 2007 will be lost, creating an instant financing gap. The timetable is already tight. Any delays from now on will add cumulatively to this financial risk.

7. Considerable pre-development work has still to be accomplished before construction can start:
    a. Obtaining Council approval
    b. Requesting and obtaining HUD permission for all of the Section 108 and EDI funds to be used on this rehab-only phase of the original project (will take 1-3 months);
    c. Completing legal/organizational work for the partnership;
    d. Carrying out an appraisal of the property
    e. Finalizing the Section 108 loan and EDI grant agreements;
    f. Obtaining binding commitments for equity and bank financing;
    g. Completing architectural plans and bid documents;
    h. Bidding and selecting the contractor(s);
    i. Completing relocation of the last tenant in the Collette building.

Worst case scenarios:

1. There are significant cost over-runs or project fails to spend all the Section 108/EDI funds before the EDI grant sunsets, creating a financing gap of approximately $100,000-$200,000. The development partners and/or the City must invest additional capital to complete the project or the City forecloses on its S.108 loan and sells the building as is. Most of the Section108 loan balance should be recoverable.
2. The project fails to meet targets for lease-up and defaults on loan repayments. In that case the bank or the City forecloses and sells the property. Again the City should be able to recover most of its Section 108 loan.
3. In either case, the City will have to continue to make repayments to HUD on the entire Section 108 loan and must identify another project or projects in which to invest the remainder of the cash balance.

Options:

1. Accept this proposal (with conditions recommended below).
2. Reject the proposal and declare EMSDC in default of its CDBG grant agreement terms because of its failure to develop the properties acquired with CDBG funds over the past six years. EMSDC would either sell the property and remit the proceeds to the City as CDBG program income, or transfer title to the City which would then sell the property[2].

    This option would be controversial and could be viewed as a unilateral withdrawal by the City from its commitment to supporting EMSDC and the South Pack Square redevelopment plan.

[2] The as-is value of the properties is uncertain. A 2004 appraisal showed it as $660,000. The current tax valuation is $1,200,000, which seems high considering the current dilapidated condition. The fair market value probably lies between these two, which would be significantly above the amount of CDBG funds invested to date. in these properties.

Recommendation: Staff recommend approval of the proposal, on the following conditions:

a) The partners must not wait on HUD's approval of the use of Section 108/EDI funds, but proceed with all speed and at their own financial risk with the legal/organizational work, architectural plans, bid documentation, and relocation, while the City makes the necessary application to HUD

b) The organizational and financial structure must be such as to allow all Section 108/EDI funds to be fully expended before the other funds (SBM equity and bank loan).

c) SBM's equity must be committed to the project at the same time as the Section 108/EDI funds, by escrow or an irrevocable letter of credit.

d) The entire property (Del Cardo, Collette, and 3 Wilson Alley) must be pledged as collateral for the Section 108 loan.

e) The partners should explore the possibility of using Historic Rehabilitation Tax Credits on the entire project.

f) Construction contracts should include incentives for timely completion.

Advantages:

- Will rehabilitate vacant buildings and reduce blight on the Block (the Del Cardo, in particular, is a key structure because of its visibility);
- Will greatly increase economic activity on the Block, including opportunities to re-establish African-American owned businesses such as the Ebony Grill;
- Will make use of the EDI grant, which otherwise will be lost
- Will make use of the Section 108 loan, which is not currently costing anything in net interest but represents an opportunity cost;
- Proposal brings in significant private equity.
- Preserves historically-significant structures (especially the Del Cardo).

Disadvantages:

- Significant risks of project failure due to cost over-runs, to loss of EDI grant funds after timetable slippage, or to higher than anticipated vacancy rates after completion.
- Consequent risk that part of the Section 108 loan funds will be lost, which will negatively impact the CDBG fund for the next 14 years.
- Continues a low density development pattern.